*United States Court of Appeals*

*for the Second Circuit*

# INTERVENOR'S BRIEF

Original

# USCA-2d Nos. 75-4209 & 76-4103 USDC No. 71-4278

## United States District Court

SOUTHERN DISTRICT OF NEW YORK

Civil Action No. 71-4278 (W.K.; Three-Judge Court)

REA EXPRESS, INC., *Plaintiff*,

v.

THE ALABAMA GREAT SOUTHERN RAILROAD COMPANY, et al., *Defendants.*

## United States Court of Appeals

FOR THE SECOND CIRCUIT

Nos. 75-4209 & 76-4103

REA EXPRESS, INC., *Petitioner*,

v.

UNITED STATES OF AMERICA and INTERSTATE COMMERCE COMMISSION, *Respondents.*

THE ALABAMA GREAT SOUTHERN RAILROAD COMPANY, et al., *Intervenors.*

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P/S

**On Review of Orders of the Interstate Commerce Commission**

**BRIEF FOR DEFENDANTS AND INTERVENORS**

UNITED STATES COURT OF APPEALS
FILED
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SECOND CIRCUIT

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## STATEMENT OF ISSUES PRESENTED FOR REVIEW

1. Whether the orders and decisions of the Interstate Commerce Commission in Finance Docket 20812 of September 25, 1959, July 28, 1975, and February 11, 1976, are unsupported by substantial evidence in the record as a whole, are without a rational basis, or are arbitrary and capricious?

2. Whether, in the absence of fraud upon the Commission, an order of the Interstate Commerce Commission authorizing the issuance of securities under Section 20a(2) of the Interstate Commerce Act can be vacated or set aside where the order was unchallenged for over twelve years and the parties to the issuance and others have relied on the validity of the order?

## STATEMENT OF THE CASE

### A. History of the Proceeding

The proceeding in Finance Docket 20812 began in 1959 when REA sought authority from the Commission under Section 20a(2) of the Interstate Commerce Act to issue $27.6 million in promissory notes ("1959 notes") to 66 of its stockholding railroads. Division 4 of the Commission, in an order dated September 25, 1959, granted the requested approval on finding that the issuance of the notes was for "a lawful

object," "compatible with the public interest," and "necessary and appropriate for and consistent with the proper performance by [REA] of service to the public as a common carrier." Railway Express Agency, Inc., Notes, 348 I.C.C. 157, 191 (1975).*/ This proceeding was contemporaneous with a proceeding under Section 5(1) of the Act for approval of the pooling provisions of a new operating agreement governing the relationships between REA and the railroads, approved September 21, 1959. Express Contract, 1959, 308 I.C.C. 545 (1959).

The notes, which were thereafter issued, replaced an antecedent open-account debt owed by REA to its stockholders (the "non-negotiable debt"). The principal of the notes was due on December 31, 1973. 348 I.C.C. at 191.

In 1969, the railroads sold their stock in REA to a new company, REA Holding Company, which had been formed by an REA management group. The sale price was slightly over $2,000,000 plus warrants in the Holding Company. The provisions for the purchase provided that the 1959 notes, which remained outstanding, could be applied at face value to the purchase of stock in the Holding Company through exercise of warrants. It was also provided that cash proceeds from the

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*/ This is the official citation for the Commission's report of July 28, 1975 from which this appeal is taken by REA.

exercise of warrants would be set aside and used solely to pay principal and interest on the notes. 348 I.C.C. at 191-92. Under its new ownership, REA continued to make interest payments on the 1959 notes until September, 1971, when suit was brought against the railroads by REA in REA Express, Inc. v. Alabama Great Southern Railroad, Civil Action 71-4278 (S.D.N.Y.). That complaint alleged *inter alia* that the non-negotiable debt had been issued in violation of Section 10 of the Clayton Act, 15 U.S.C. § 20, and that it had also been issued without Commission approval under Section 20a of the Interstate Commerce Act, 49 U.S.C. § 20a, and was thus void, so that the 1959 notes were likewise void because they had been issued without valid consideration. An amended complaint added, among other things, the contention that the Sherman Act had been violated by the joint setting of the interest rate on the non-negotiable debt.

Thereafter, the Commission intervened in the lawsuit and asked the court to stay the litigation so that the Commission might have an opportunity to review the propriety of its 1959 order authorizing issuance of the notes. This intervention was stimulated by the Office of the General Counsel which wished to examine the question whether the non-negotiable debt was in fact equity rather than debt. 348 I.C.C. at 157, 161-62. On December 20, 1972, the three-judge district court granted the Commission's motion and

stayed the litigation for the express purpose of allowing the Commission to reconsider its 1959 authorization as well as to consider questions of antitrust immunity and any other questions that the Commission regarded as pertinent.

The Commission reopened the proceeding in Finance Docket 20812 on January 9, 1973. (C.I. 10)*/ The matter was assigned to an Administrative Law Judge for the purpose of supervising discovery efforts. (C.I. 34) On his own initiative, and without the benefit of the extensive discovery that was being commenced concerning the origins of the non-negotiable debt or of briefs by the parties, the Administrative Law Judge issued a "Tentative Statement of Facts and Conclusions." (C.I. 47) Following reasoning similar to that which prompted the Office of General Counsel's interest, the Administrative Law Judge concluded that there was no debt and that, therefore, there was no consideration for the 1959 notes. 348 I.C.C. at 200-03.

Thereafter, extensive discovery was had of REA and of the railroads concerning the history and nature of the non-negotiable debt from as early as 1928, as well as the circumstances concerning the issuance of the 1959 notes. The railroads and REA produced thousands of pages of documents

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*/ "C.I." refers to the Commission's certified index of the record, filed with the court by letter of May 6, 1976.

from their files on these questions and provided sworn interrogatory answers concerning their accounting and tax treatment of the non-negotiable debt and the 1959 notes during a 40-year period. After discovery, the parties submitted to the Commission hundreds of pages of briefs, verified statements, and exhibits covering a number of issues involving the non-negotiable debt and the 1959 notes.

On July 28, 1975, the Commission issued a 62-page Report that canvassed in great detail the facts and the legal issues raised by the parties. 348 I.C.C. at 157-218. On the basis of the extensive discovery that was had, the Commission was able to reconstruct the events of 1929 surrounding the creation of the non-negotiable debt. The Report concluded, *inter alia*, that non-negotiable debt was in fact debt, that the Commission's prior Order of September 25, 1959, "was correctly and appropriately issued" and that the issuance of the notes had been exempted from the operation of the anti-trust laws under Section 5(11) of the Interstate Commerce Act. 348 I.C.C. at 206, 211-12, 218.

REA filed a petition for reconsideration that was denied by the Commission on February 11, 1976 (App. __.)*/ The Commission reiterated its conclusions that the non-negotiable debt was a valid debt and adequate consideration for the

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*/ A deferred joint appendix is to be filed.

promissory notes, that the issuance of the notes in 1959 had been "for a lawful object" and was "compatible with the public interest," and that the notes were exempt from the operation of the antitrust laws under Section 5(11).

B. The Petitions for Review

On April 8, 1976, REA filed two substantially identical petitions for review, one in the Southern District of New York under the same case number as it filed its complaint against the railroads (No. 71-4278), and the other in the Court of Appeals for the Second Circuit (No. 76-4103).*/ The petitions allege that the Commission erred in rejecting the Administrative Law Judge's conclusion that the notes were void for lack of consideration (the Commission erring because the underlying non-negotiable debt had been created in violation of Section 10 of the Clayton Act, a violation that the Commission supposedly had no power to sanction). Second, the petitions allege that the Commission erred in concluding

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*/ On September 26, 1975, REA filed a petition for review of the Commission's July 28, 1975 decision in the United States Court of Appeals for the Second Circuit (No. 75-4209). The petition asked that the Commission's decision be set aside on grounds *inter alia* that it was not supported by the evidence, that REA was deprived of a proper hearing, that the Commission lacked jurisdiction, and that the Commission ignored pertinent evidence and relied on incompetent evidence. This early petition was filed as a protective measure and appears superseded by the petitions of April 8, 1976. Many of the grounds noted in the earlier petition were not argued in REA's brief of June 1, 1976.

that the issuance of the 1959 notes was properly authorized under Section 20a of the Interstate Commerce Act (the Commission erring because the issuance of the notes was not consistent with the public interest, adversely affected REA's ability to attract capital and to pay creditors, threatened REA's solvency, and "directly and significantly contributed to REA's bankruptcy"). The petitions pray that the Commission's approval of the promissory notes be set aside, that the notes themselves be declared null and void, and that the railroads be required to pay into the Bankruptcy Court all payments which they have received from REA over the years on the promissory notes.

C. The Jurisdictional Question

Prior to 1975, actions to vacate or set aside orders of the Interstate Commerce Commission had to be brought in three-judge district courts. In 1975, new legislation provided that the courts of appeals would have exclusive jurisdiction of proceedings to set aside orders of the Commission.*/ Pub. L. 93-584, 88 Stat. 1917, amending 28 U.S.C. §§ 2321-25.

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*/ Section 10 of the legislation, which became effective on January 2, 1975, provides that "actions to enjoin or suspend orders of the Interstate Commerce Commission which are pending when this Act becomes effective shall not be affected thereby, but shall proceed to final disposition under the law existing on the date they were commenced." Since all three petitions for review which have been filed in this proceeding were filed after January 2, 1975, this clause is inapplicable here.

REA has filed its petitions both in the Court of Appeals for the Second Circuit and with the three-judge district court.

We believe that jurisdiction over the Commission's decision of July 28, 1975 is governed by 28 U.S.C. § 1336(b) and is lodged exclusively with the three-judge district court:

> "When a district court or the Court of Claims refers a question or issue to the Interstate Commerce Commission for determination, the court which referred the question or issue shall have exclusive jurisdiction of a civil action to enforce, enjoin, set aside, annul, or suspend, in whole or in part, any order of the Interstate Commerce Commission arising out of such referral."

This statute was adopted in 1964 to deal with situations in which a Commission proceeding is an offshoot of an earlier lawsuit. Pub. L. 88-513, 78 Stat. 695 (1964). Its purpose was to prevent the inefficient bifurcation of lawsuits when matters were referred by a district court to the Commission. It was thought that delay and confusion would be avoided if judicial review in such circumstances was had by the same court that had jurisdiction over the original litigation and which also had a better understanding of the facts and circumstances involved in the lawsuit. 2 U.S. Code, Cong. & Admin. News, 3235-39 (1964).

The purpose of Section 1336(b) indicates its applicability to this case, since the issues involved in the Commission's decision are directly related to those in the

pending lawsuit in Civil Action 71-4278. Moreover, this Court's order of December 20, 1972, staying the present litigation, can be regarded as a "referral" within the meaning of Section 1336(b), as held in Leonard Bros. Trucking Co. v. United States, 301 F. Supp. 893, 898 (S.D. Fla. 1969) (three-judge court).

If we are correct in concluding that Section 1336(b) applies to the Commission's decisions of July 28, 1975, and February 11, 1976, the petitions for review of these decisions filed in the Court of Appeals for the Second Circuit should be dismissed.

D. Statement of Facts

The Commission's decision of July 28, 1975, rendered after voluminous discovery was had and after extensive briefing, recites in detail the history of the non-negotiable debt and the 1959 promissory notes as well as the background of railroad ownership and control of REA. 348 I.C.C. at 166-92. REA's brief does not in terms take specific issue with any of the factual findings of the Commission concerning this history, which includes the manner in which the non-negotiable debt was created, REA's non-profit status prior to 1961, its relationship to its railroad stockholders, the several Commission proceedings since 1929 involving REA, and the circumstances of the sale of REA in 1969 to an inside management

group. But although no attempt is made to show wherein any particular finding of the Commission is unsupported by or contrary to the evidence, REA ignores the necessary implications of the Commission's findings, and ignores its conclusions. In particular, REA repeatedly asserts that the non-negotiable debt was a misappropriation by the railroads of REA's capital, but fails to challenge the extensive evidence on which the Commission relied in reaching a contrary conclusion.

The pertinent facts as found by the Commission are summarized below, with citiations to the supporting evidence in the record.

REA was created in 1929 as a wholly-owned joint venture of 86 railroads through which they would engage in the express business. (RR Exs. 2, 3) */ Railroad ownership

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*/ From among the hundreds of documents produced during discovery, REA and the railroads each selected a group which were submitted to the Commission as exhibits in support of their briefs. These sets of exhibits are referred to in the Commission's certified index as items 198, 200-02, and 204. For clarity, they will be cited herein by the exhibit numbers used in the Commission proceeding and identified as railroad ("RR") or REA exhibits. Several of these exhibits will be included in the appendix, and will be indicated herein as follows: App. __. Other exhibits have been submitted to the court as attachments to prior affidavits, particularly the affidavit of S. William Livingston, Jr., filed in Civil Action 71-4278 (S.D.N.Y.) on June 1, 1976 (hereafter "1976 Livingston Aff."). The two exhibits cited above were exhibits 1 and 2 to that affidavit; other citations to exhibits will likewise be cross-referenced for the court's convenience.

and control of REA were approved by the Commission under Section 5(2) of the Interstate Commerce Act. Securities and Acquisition of Control of Railway Express Agency, Inc., 150 I.C.C. 423 (1929). At the same time, the Commission under Section 5(1) approved the pooling provisions of a standard express operations agreement (SEOA) between REA and the railroads. Id. REA issued bonds to the public to raise the $32 million needed to acquire the express business from American Railway Express Company. The issuance of the bonds was approved by the Commission under Section 20a of the Interstate Commerce Act. Id. See also 348 I.C.C. at 175-77.

Under the 1929 SEOA, REA was a non-profit agency, i.e., it first paid its expenses out of its gross revenues and then paid what was left over to the railroads who furnished transportation services as "rail transportation revenue." (RR Ex. 2, pp. 2, 8, 11, 66-73, 1976 Livingston Aff., Ex. 1) 348 I.C.C. at 169-70. The SEOA contained a provision permitting any "Surplus Applied to Sinking and Other Reserve Funds" to be deducted as an expense by REA before computing the amounts to be paid to the railroads as "rail transportation revenue." (RR Ex. 2, p. 73, 1976 Livingston Aff., Ex. 1) 348 I.C.C. at 170. This provision could have been used by REA to repay its outstanding $32 million bond issue, the principal of which was due in equal semi-annual installments over twenty years. This provision in the SEOA, however, was

not mandatory and, for reasons which are reviewed in great detail in the Commission's Report (pp. 170-81), it was determined not to use this method for retiring REA's public bonds. Moreover, as found by the Commission after a detailed review of the contemporaneous documents, the Commission in 1929 was "adequately advised" (348 I.C.C. at 205) and "fully informed" (Order of February 11, 1976, App. __) prior to approving railroad control of REA that the sinking fund provision in the SEOA might not be used and that an alternative device for repayment was under consideration.*/ The indenture on REA's bonds, as finally drafted and submitted to the Commission on March 5, 1929, made it plain that the bonds were to be repaid out of "rail transportation revenue," i.e., from the amounts due to the railroads for their transportation services. (RR Ex. 24, p. 29, App. __) 348 I.C.C. at 177-79.

On April 11, 1929, at the initial meeting of the permanent REA Board, the Board adopted a resolution whereby REA would deduct from the payments of "rail transportation revenue" owed to its railroad stockholders an amount sufficient to meet the semi-annual principal payments on the bonds. The deductions were to be treated as "advances" by the railroads to REA that would bear interest at 5 percent. (RR Ex. 27, 1976 Livingston Aff., Ex. 7) 348 I.C.C. at 179.

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*/ See generally RR Ex. 3, pp. 34-35, 1976 Livingston Aff., Ex. 2; and RR Exs. 4-14, App. __.

REA's bonds were refinanced in 1938 by the issuance of notes to the public. 348 I.C.C. at 183-84. REA repaid the principal on the notes by again taking advances from its stockholders. The procedures for making the advances were set forth in 1938 in identical "stockholders agreements." Railway Express Agency, Inc., Notes, 230 I.C.C. 478 (1938). Also in 1938, the Commission's Director of Finance reviewed the "stockholders agreements" and advised REA that they did not require Commission authorization under Section 20a. (RR Exs. 53, 54, App. __) 348 I.C.C. at 183-84.

Advances were made to REA by the stockholding railroads through 1948 pursuant to the April 11, 1929 resolution and the 1938 stockholders agreements, and resulted in the creation of an open-account non-negotiable debt by REA to the railroads of approximately $28 million. Between 1929 and 1959, REA and the railroads treated the advances as a valid debt on their books. The railroads treated as income for tax purposes the full amount of rail transportation revenue owed to them prior to the deduction for advances. 348 I.C.C. at 181-82.

REA remained a non-profit entity until 1961, paying all its revenues to the railroads after deducting its own expenses. However, "there was a net annual multi-million dollar deficit from the cost to the railroads providing

services and facilities to REA for express operations despite their revenues from REA." 348 I.C.C. at 189.*/

As a non-profit agency REA could be indifferent to expenses since if "REA's own expenses increased faster than its revenues, REA's expenses would be fully covered while the amounts paid to the railroads would decrease proportionately, even though the railroads' own costs for carrying express might be increasing." 348 I.C.C. at 189. In an effort to achieve increased efficiency in the handling of express traffic, and to place REA on a more commercial basis in its relationship to the railroads (though it continued to be wholly owned by the railroads whose representatives continued to comprise, with permission of the ICC, the bulk of its board), a new SEOA was adopted in 1959 under which REA would be able to earn profits or incur losses after 1961. The railroads would provide transportation service on a basis related to their out-of-pocket costs. (RR Exs. 88, 90, 91, 1976 Livingston Aff., Exs. 14, 16 and 17) 348 I.C.C. at 189-91. At the same time, promissory notes totaling $27.6 million were issued by REA to the railroads to formalize and replace the non-negotiable debt.

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*/ See also Express Rates, 1938-1939, 231 I.C.C. 471, 505-06 (1939); Increased Express Rates & Charges, 1946, 269 I.C.C. 161, 178 (1947); 61 I.C.C. Ann. Rep. 35 (1947); Increased Express Rates & Charges, 1949, 277 I.C.C. 249, 271 (1950); Railroad Passenger Train Deficit, 306 I.C.C. 417, 419-20, 439 (1959).

The Commission approved the new SEOA under Section 5(1) on September 21, 1959. Express Contract, 1959, 308 I.C.C. 545 (1959). Four days later, the Commission authorized under Section 20a the issuance of the notes to the railroads to evidence and replace the non-negotiable debt. 348 I.C.C. at 191. (In the reopened proceedings REA contended that the railroads had made material misrepresentations to the Commission in seeking approval under Section 20a. But after reviewing its files and the materials uncovered in discovery, and after receipt of briefs on the issue, the Commission found that REA'a application in 1959 for authority to issue the notes "disclosed all facts insofar as they were material to such authorization" (Order of February 11, 1976, App. __.) The Commission also found that the notes were authorized "in furtherance" of approval under Section 5(1) of the 1959 SEOA and were a "necessary step" in achieving the changes in REA-railroad arrangements that were the purpose of the new SEOA. 348 I.C.C. at 212.

In the mid-1960's the earnings of REA were poor and efforts to find a purchaser of the railroads' interest were made. In 1969, ten years after issuance of the notes, REA was sold by the railroads to a new company, REA Holding Corporation, which had been formed by a group of REA

executives who were acquainted with the financial difficulties facing the express business.*/ The purchase price was slightly more than $2 million plus warrants in the Holding Corporation. The notes remained outstanding and, by terms of the purchase arrangement, could be used to purchase warrants; moreover, cash proceeds received by the Holding Corporation from exercise of the warrants would be contributed by it to REA to be used to repay the notes. (RR Exs. 103-06, Livingston Aff. of April 28, 1975, Exs. A, E) 348 I.C.C. at 191-92. Interest payments on the notes continued to be made until September, 1971, when REA brought its suit against the railroads challenging the validity of the notes and refused to make further interest payments. REA also refused to pay the principal on the notes when it became due in December, 1973.

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*/ In 1970, Tom Kole, a member of the management group that arranged for the acquisition of REA and then REA's Chief Executive Officer, publicly stated that "at the time that new management took the helm of REA Express a year and a half ago, it was certainly no secret that the company was in bad financial shape; in fact, it was on the verge of bankruptcy." Ex. H to Affidavit of S. William Livingston, Jr., filed in Civil Action 71-4278 (S.D.N.Y.) on April 28, 1975 (hereafter referred to as "Livingston Aff. of April 28, 1975").

E. Events After the Commission Reopened its Proceeding

On February 11, 1975, after the parties filed their briefs with the Commission, REA filed for reorganization under Chapter XI of the Bankruptcy Law. In a press release at the time of the application for reorganization, REA's President was quoted as making the following observation:

> "When the present management and outside investors purchased REA from the railroads in 1969, the company was losing almost $50 million dollars a year. Since that time we have reduced costs by more than $100 million dollars and in calendar 1974 achieved an operating profit of $2.8 million dollars. The first in nine years. The effects of the recession has literally pulled the rug out from under our carefully planned recovery program and our cash position during the past two months has become critical. Our attempts to obtain Government backed loans and relief legislation have not been successful." (Livingston Aff. of April 28, 1975, Ex. G)

On November 6, 1975, REA was adjudged a bankrupt and is being liquidated.

## ARGUMENT

As we understand the petitions for review and REA's brief, two major errors are assigned. REA's first set of contentions are that Section 10 of the Clayton Act was violated in the creation of the non-negotiable debt,

that the Commission lacked power to provide immunity from Section 10, and that by reason of the Section 10 violation the non-negotiable debt was void. Since the Commission did not rule on whether Section 10 was violated by creation of the non-negotiable debt, we assume that REA argues that the Commission, in passing on the Section 20a application in 1959, was obliged to but did not inquire whether the underlying debt had been created in violation of Section 10 of the Clayton Act and that, had it done so, it would have been obliged to deny the application because of the invalidity of the underlying debt for which the notes were issued.

The second major contention is that the Commission erred in providing the Section 20a authorization requested in 1959, and in upholding that order in 1975 and 1976, because the Commission should have realized that the notes were severely injurious to REA and were in fact a significant cause of REA's bankruptcy.

The two major arguments are interlineated with charges as to fraud on creditors and with the recurrent claim that the 1929 transaction which created the non-negotiable debt constituted one of the historically great frauds of railroad finance.

We turn first to contentions related to the claim that Section 10 was violated in the creation of the non-negotiable debt and that, accordingly, Section 20a authorization of the 1959 notes was improper.

I. The Validity of the Commission's 1959 Order Authorizing the Notes Under Section 20a Is not Impaired by the Alleged Applicability of Section 10 of the Clayton Act to the Non-Negotiable Debt.

The first argument made in REA's brief of June 1, 1976, is that the "Commission erred in failing to notice that Section 10 of the Clayton Act" (p. 8) was violated when the non-negotiable debt was created. The transaction that supposedly violated the Clayton Act is described as the "conversion of an REA public bond issue into private interest-bearing debt to REA's railroad owners." (p. 8). It is alleged that creation of the non-negotiable debt represented the "pocket[ing of] REA's sinking fund revenues" (p. 9), a "misappropriation of [REA's] capital" (p. 14), and an unlawful "assertion of title" by the railroads to REA's assets (p. 12), and that it was fraudulent as to REA's creditors. And it is claimed that this alleged misdealing is a classic example of the evils Section 10 of The Clayton Act was supposed to prevent.

These charges are unfounded and are at odds with the Commission's conclusions after extensive examination of the circumstances surrounding the creation of the non-negotiable debt. Yet REA makes virtually no effort to point to any finding by the Commission that it now regards as erroneous or as unsupported by the evidence, nor does it cite evidence of its own to support its broad charges. This

is plainly insufficient to meet REA's burden in this proceeding of showing that the Commission's decision was not "supported by substantial evidence" or that it was "an abuse of discretion." City of New York v. United States, 344 F. Supp. 929, 939-40 (E.D.N.Y. 1972) (three-judge court).

We shall first review why the claims of misdealing, said to be the heart of the Section 10 violations, are without substance in fact and why the Commission's contrary conclusion may not be disturbed. We shall demonstrate why, as a matter of law, Section 10 was inapplicable, and, finally, we shall explain why the Commission's Section 20a order authorizing the 1959 notes could not be affected by the Section 10 status of the non-negotiable debt.

### A. The Allegations of Fraud, Self-Dealing, and Misappropriation of Capital are Unfounded.

The accusation that there was a "conversion" of REA's "sinking fund" implies that REA was unlawfully stripped of assets that it could have used to retire its public debt. But there is no factual predicate for this proposition, as the record before the Commission plainly demonstrated. Moreover, REA has not met its burden of demonstrating that the Commission's conclusion that REA was indebted to the railroads is without substantial basis.

### 1. <u>The Creation of the Non-Negotiable Debt Was Not a Mulcting of REA</u>

The only apparent grounds for questioning the lawfulness of the non-negotiable debt are that it was inconsistent with the SEOA or with the Commission's 1929 approvals of the pooling provisions of the SEOA and railroad control of the express business. Both grounds were considered and rejected by the Commission, as the evidence plainly required. 348 I.C.C. at 204-05; Order of February 11, 1976, App. __.

Article V(4) of the 1929 SEOA contained the formula for computing amounts to be paid by REA to the railroads for transportation services. It provided that all revenues of REA be computed and that there be deducted various items of expense as well as certain "profit and loss debits" specified in Article V(4)(j). (RR Ex. 2, p. 73, 1976 Livingston Aff., Ex 1). One of these "debits" was an account for "Surplus Applied to Sinking and other Reserve Funds." But there was no provision in that article or elsewhere in the SEOA requiring the use of that account as the vehicle for repaying REA's public bonds. For a variety of reasons, which are fully described in the Commission's decision, 348 I.C.C. at 170-81, it became apparent in late 1928 and early 1929 that it would be inappropriate to use that account. By the April 11, 1929 resolution passed at the first meeting

of the REA permanent Board of Directors, the non-negotiable debt arrangement was created.

The contemporaneous conduct and statements of the parties involved confirm that the use of the "sinking fund" provisions was not contractually mandated. After certain issues had been raised by the "Williams Roads," the Legal Committee that had drafted the SEOA and the incorporation documents for REA issued an opinion on December 3, 1928, stating that "all the members of the Committee are of the opinion that the provisions of [the 1929 SEOA] would not preclude the Board of Directors of the Railway Express Agency, Incorporated, from providing as between the participating railroads for proprietary interests by them in a sinking fund set up to protect a bond issue corresponding to their respective contributions thereto, and the Legal Committee has recommended that such action be so taken." (RR Ex. 8, App. __), 348 I.C.C. at 173-75. The Committee went on to say that REA's Board of Directors would have authority to determine the method by which REA would raise money to repay its bonds. (Id.)

The Legal Committee's opinion was then circulated to the railroads on January 23, 1929 (RR Ex. 14, App. ___) and was made part of the record in the hearing before the Interstate Commerce Commission on January 24, 1929. (RR Ex. 3, pp. 34-35, 1976 Livingston Aff., Ex 2). It was made clear

at the hearing that it was on the basis of the Legal Committee's opinion*/ that several railroads had agreed to participate. (*Id.*) 348 I.C.C. at 173.

At one of the first meetings of the REA board, on February 28, 1929, a resolution was presented in substance identical to the April 11, 1929 resolution, but action was postponed until a board had been elected by the stockholders. (RR Ex. 26, App. __). It was noted at this February 28 meeting that the Legal Committee had ruled that such a resolution was permissible and recommended it. Then, on April 11, 1929, the resolution providing for advances to retire the bonds was adopted, and it was again noted that the Legal Committee had approved the lawfulness of the resolution and that it recommended its adoption. 348 I.C.C. at 179.

In later years, the parties continued to observe the principle that the use of the surplus accounts in Article V(4)(j) was only "voluntary on the part of the Agency," and was not required, and that REA could raise funds for any lawful purpose (including the repayment of the bonds) by borrowing or taking advances from its stockholders. (RR Exs. 30, 31, 34, 65, App. __) 348 I.C.C. at 180-181.

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*/ Certain railroads signed the SEOA on the basis that the intent of the parties as to the proper construction of the SEOA would be clear by the circulation of the Legal Committee's opinion to the other railroads and by its formal submission to the Commission. RR Exs. 10, 11, 13, App. __.

In short, the parties to the SEOA were expressly advised in 1929 that the SEOA was not to be interpreted as mandating the use of the surplus account for purposes of raising money to repay the 1929 bonds. The Board of Directors of REA, as well as the Legal Committee, were all in agreement that the 1929 SEOA permitted the board to adopt the resolution of April 11. All parties acted on the basis of this understanding. The Commission therefore correctly concluded that the non-negotiable debt was a "valid debt," and that "[t]he parties did so contract in this case." 348 I.C.C. at 204.

Nor can there be any basis to a charge that the April 11, 1929 resolution creating the non-negotiable debt was inconsistent with the Commission's prior approval of railroad ownership of REA and of the pooling provisions of the SEOA. The Commission's 1929 decision expressly stated that "we are not passing upon" provisions such as Article V(4)(j). 150 I.C.C. at 434. Moreover, the Legal Committee's opinion, which endorsed the proposal that the stockholders have "proprietary interests . . . in a sinking fund set up to protect a bond issue," had been given to the Commission at its hearing on January 24, 1929 with explanatory testimony. (Ex. 3, pp. 34-35, 1976 Livingston Aff., Ex. 2.) 348 I.C.C. at 173-5. The Commission was therefore clearly correct in concluding that the non-negotiable debt "was within the permissible bounds of the Commission authorization" in 1929,

and that it was "adequately advised" and "fully informed" that the surplus accounts in the SEOA might not be used to retire REA's public debt. 348 I.C.C. at 205; Order of February 11, 1976, App. __.

Since the decision not to use the sinking fund account under Article V(4)(j) was one under contemplation at the inception of REA, and was one as to which the Commission had notice prior to its approval of the pooling arrangements and of railroad ownership of REA, and was indeed one that was necessitated to induce the participation of various railroads, it is difficult to discern on what basis, decades after the event, the Commission or the Court should view that decision as impermissible or as mulcting.

For good and sufficient reasons in organizing REA the stockholders determined that the sinking fund payments should not be considered a deductible expense prior to computation of the rail transportation revenues to be paid to the railroads for transportation services. As a result of that decision, revenues received by non-stockholding railroads were not docked by sinking fund payments; and the decision to use a system of advances on the basis of shares of stock avoided imbalances between contributions to the sinking fund and rights on liquidation (which would be on a stockownership basis) which certain railroads criticized. 348 I.C.C. at 171-73.

Nor can it be said that REA was in any cognizable way injured by the change.

The REA brief does not suggest that REA might have secured a lower interest rate on the advances had there been competitive bidding. In view of REA's non-profit status under the 1929 and 1954 operating agreements, where all of REA's revenues were paid to the railroads after deduction of its own expenses, there can be no claim by REA of injury on that account. Since interest payments were deducted by REA as one of its own expenses prior to calculation of rail transportation revenue, each dollar of interest paid by REA reduced by a dollar the amount it paid out to the railroads as rail transportation revenue,*/ and conversely a reduction in the interest rate would have been distributed out to the railroads in the form of increased rail transportation revenues.

Under both the system of advances actually followed and the system using the Article V(4)(j) account, the amounts actually transferred in cash to the stockholder railroads as rail transportation revenue were the same. (While the amounts needed to retire the 1929 bonds were credited to the railroads as rail transportation

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*/ As noted in the contemporaneous documentation, the interest rate on the advances was a "wash transaction." (RR. Exs. 45, 52, App. __.) 348 I.C.C. at 183.

revenue under the April 11 resolution, they were in fact set aside by REA to retire the 1929 bonds and 1938 notes and were not paid to the railroads.) The effect of not using the surplus accounts was that at the end of twenty years, the railroads' total ownership interest in REA was represented by approximately $28 million in non-negotiable debt and stockholdings of nominal value; had the Article V(4)(j) account been used the railroads would have owned an express agency identical in size to that which actually resulted, except that their ownership interest in REA would have been represented by stock rather than debt. (Verified Statement of Prof. James E. Walter, p. 6, App. ___.)

REA did not in any way suffer from the fact that the investment of its railroad stockholders was represented by debt and stock rather than stock alone. What made REA's debt acceptable was the fact that the railroads underwrote its financial adversities.*/ (RR. Ex. 102, App. ___.)

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*/ The initial issue of bonds in 1929 was not secured by a lien on REA's physical property but by an assignment to the indenture trustee of REA's rights under the operating agreements. 348 I.C.C. at 176.

2. The Non-Negotiable Debt Did Not Defraud REA's Creditors

REA's brief repeatedly asserts that the non-negotiable debt was a "fraud" on REA's other creditors (pp. 7, 9, 13, 14, 15). No explanation is advanced as to content of this "fraud."

The facts preclude any such claim. The non-negotiable debt was not created secretly. REA's annual reports from 1929 on provided exact details about the debt of REA to its stockholders, and these reports were at all times available to the Commission, to REA's creditors, and to the public. (RR Ex. 29, 1976 Livingston Aff., Ex. 8.) 348 I.C.C. at 181. The arrangements for advances were described in a published opinion by the Commission in 1938 when it approved the issuance of notes by REA. 230 I.C.C. at 480. The Commission's Director of Finance in 1938 reviewed the arrangements for making advances and did not question their validity. (RR Exs. 53, 54, App. __.) 348 I.C.C. at 183-84. The Internal Revenue Service made a thorough evaluation of REA's accounting practices, including the non-negotiable debt, all as explained in a published opinion of the Tax Court, with no suggestion that the debt was in any way unlawful. Railway Express Agency, Inc., 8 Tax Ct. 991 (1947), rev'd on other grounds, 169 F.2d 193 (2d Cir. 1948), cert. denied, 336 U.S. 944 (1949).

Moreover, since REA was a non-profit organization, the Commission and creditors from the inception of REA well understood that the railroads in effect were standing behind REA's debt. The arrangement whereby transportation revenues to the railroads were not computed until after the deduction of expenses meant that the railroads would not receive revenues until after the interest on outside debt was paid. The Commission noted in 1962 that "the railroads underwrote its financial adversities which made [REA's] debt readily acceptable to lenders notwithstanding the fact that [REA's] capital was insignificant." (RR Ex. 102, App. __)

Nor does REA identify a single creditor of REA during the life of the non-negotiable debt -- between 1929 and 1959 -- who was defrauded, or who did not receive full repayment of his credit, or who was in any way injured by the existence of the advances. The record before the Commission provides no evidence of any such creditor and it is implausible that any exist in view of the guaranteed coverage of REA's expenses at that time.*/

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*/ In a recent decision dismissing, per Bangor Punta, a complaint by REA against its former railroad owners on insurance matters, Chief Judge Jones noted that "counsel for REA at oral argument did not know of any instance of a creditor (other than the railroad defendants) who had a debt outstanding prior to the change of ownership in 1969." REA Express, Inc., v. Travelers Ins. Co., 406 F. Supp. 1389, 1395 (D.D.C. 1976).

The allegations of fraud receive no support from the fact of the 1954 SEOA's provision that in the event of liquidation the non-negotiable debt was to be treated as "capital debt" for purposes of pro rata distribution of REA's remaining assets. (REA Br., p. 13) The 1954 SEOA provision was designed to provide an orderly arrangement for the payment of REA's debts and the distribution of its assets in the event of liquidation. 348 I.C.C. at 186-87. It did not abruptly transmute the non-negotiable debt, which had been treated as such for 25 years, into an equity interest or into a nullity. Indeed, the 1954 SEOA expressly provided that a railroad withdrawing from the SEOA could apply up to 75 percent of its advances against the purchase price of express property on its lines. 348 I.C.C. at 186. The 1954 provision did not preclude the future issuance of promissory notes to formalize the debt and to provide the terms for its repayment in the event of a change from the non-profit concept. And, as will be seen below, any suggestion that creditors were defrauded in 1959 and need redress now is without any hint of a basis in fact, let alone the record of this proceeding.

Nor does REA anywhere explain why an attempt to create a preference for a debt as against other creditors in the event of liquidation (REA Br., p. 9) -- which is what

the contention would amount to if it had any support in the record -- should invoke as a remedy the invalidation of the 1959 notes as distinguished from an appropriate subordination to injured creditors. In fact, there is no evidence of any such unlawful preference.

Finally, it must be noted that REA's repeated allegations of fraud, mulcting, and injury by the railroads against their wholly-owned express agency during the period of the non-negotiable debt are a perverse misdescription of the facts of actual injury. The reality of the situation was that the railroads were subsidizing the express business as a consequence of the non-profit provisions of the SEOA. 348 I.C.C. at 188-89.

Rather than "mulcting" REA, they were in fact committing millions of dollars in uncompensated transportation services to REA.

In 1939, Commissioner Eastman recognized that the railroads had been receiving "inadequate compensation" from REA. Express Rates, 1938-1939, 231 I.C.C. 471, 506 (1939). He referred to a cost study by the Federal Coordinator of Transportation which had found that the railroads in 1933 sustained "expenses and taxes in the express service which exceeded receipts from [REA] by about $54,000,000, and that the receipts were in fact somewhat less than the direct, or out-of-pocket, expenses." *Id.* at 505.

The Commission's annual report in 1947 stated that REA estimated the payments "to the railroads for handling express traffic in 1947 would fall short by at least $70,000,000 of adequately compensating the railroads for their services." 61 I.C.C. Ann. Rep. 35 (1947). In 1948 the Commission reported that a railroad cost study projected a railroad express deficit for that year of from $51 million to $93 million, depending on whether a charge for federal income taxes and a return on investment were included. Increased Express Rates and Charges, 1946, 273 I.C.C. 231, 238, 243 (1948). In a rate proceeding in 1949, the Commission concluded that REA's revenues in 1948 "would fall short of providing enough revenue to cover the cost to the class I railroads of transporting express shipments by approximately $81,944,139." Increased Express Rates and Charges, 1949, 277 I.C.C. 249, 271 (1950).

In 1951, the Commission found that "the shortage in rail express revenue . . . amounts to approximately $50 million based on the proposed rates." Increased Express Rates and Charges, 1951, 283 I.C.C. 431, 487 (1951). In 1953, the Commission "accepted as substantially accurate" a railroad estimate of their express deficit of $92 million in 1951 and $48 million in 1952, excluding taxes and return on investment. Express Rates and Charges, 1953, 289 I.C.C. 249, 251, 257 (1953). The out-of-pocket deficit incurred by the railroads for 1956 was estimated to be at least $14

million and perhaps as high as $108 million if certain adjustments were made and federal taxes and return on investment were included. Increased Express Rates and Charges, 1957, 304 I.C.C. 699, 703, 744-48 (1958).

In 1959, the Commission noted that express payments to the railroads had declined from 1947 to 1957 despite generally increasing costs, and that the railroads estimated the 1955 express deficit to be $50 million. Railroad Passenger Train Deficit, 306 I.C.C. 417, 419-20, 439 (1959). And two years later, a Senate Committee found that prior to 1959 the express business had been "losing money for the railroads for many years." S. Rep. No. 530, 87th Cong., 1st Sess. (1961), printed in 1961 U.S. Code Cong. & Admin. News 2175, 2179 (1961). But, as the Committee noted, this loss did not affect REA, which "always broke even on its own books."

In the light of such a history, the failure of the ICC in 1959 -- or again in 1975 when reconsidering its 1959 order -- to discern the supposedly egregious ravaging of REA by the totality of its owners is understandable. Any other decision would not be.

### B. The Non-Negotiable Debt Was Not Created in Violation of Section 10 of the Clayton Act

The REA brief contends that the core of the Section 10 violation here lies in the "bankruptcy producing . . .

debt manipulation" (p. 15), the railroads' "manipulation of REA's sinking funds to create unpayable debt to themselves" (p. 13), "defrauding other competitors" (p. 14), the "self-serving acquisitions of common carrier debt" (p. 23), etc. The brief places little stress on competitive bidding and indeed suggests that the competitive bidding requirement was merely intended to take care of "emergencies" (p. 25). But cf. United States v. Boston & Me. R. Co., 380 U.S. 157, 160 (1965). To the extent that REA's argument is premised on the proposition that the creation of the non-negotiable debt was mulcting or manipulation or misappropriation of assets, etc., the previous section of this brief has demonstrated that these contentions were dealt with in minute detail by the Commission in its reopened proceeding and were correctly and authoritatively rejected. REA has not attempted even the beginning of a showing that the Commission was wrong on its facts or lacked substantial bases for its conclusions.

To the extent that REA is remitted to the theory of its lawsuit -- i.e., that the essence of the Clayton Act violation was that the non-negotiable debt was issued without competitive bidding -- we contend that the basic legal premise of the first argument in REA's June 1, 1976 brief, that the non-negotiable debt plainly violated Section 10 of

the Clayton Act, */ is erroneous. Section 10 had no applicability to the advances and, in any event, the transaction involving creation of the debt was exempt from the operation of the antitrust laws.

1. <u>Inapplicability of Section 10</u> **/

Section 10 makes it a criminal violation for a common carrier to "have any dealings in securities" of more than $50,000 in one year with another corporation when there exist interlocking directors and officers between the carrier and the other corporation. 15 U.S.C. § 20. The non-negotiable debt was carried in open accounts on the books of REA and the railroads, was not evidenced by bonds, notes, stock or other forms of commercial paper, and did not constitute "securities" within the meaning of the Clayton Act.

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*/ No claim is made in the June 1, 1976 brief that the 1959 notes were issued in violation of the Clayton Act. We contend that no such claim could be supported in this case of transactions between common carriers, acting jointly, and their wholly-owned facility. "Memorandum in Support of Supplemental Motion for Summary Judgment by Certain Railroads," filed on June 1, 1976, pp. 68-73. In addition, the issuance of the notes was exempt from the operation of the antitrust laws as a result of Commission approval and regulatory authority. *Id.* at 34-59. 348 I.C.C. at 211-12.

**/ See "Memorandum in Support of Supplemental Motion for Summary Judgment by Certain Railroads," filed on June 1, 1976, pp. 68-77 and 79-86, for a more detailed discussion of this point.

The term "securities" is not defined in the Clayton Act.*/ However, six years after the Clayton Act was passed, Section 20a of the Interstate Commerce Act was adopted, requiring ICC approval of the issuance of railroad securities, defining "securities" to be "any share of capital stock or any bond or other evidence of interest in or indebtedness of the carrier . . . ." Transporation Act of 1920, Ch. 91, § 439, 41 Stat. 494, codified at 49 U.S.C. § 20a(2). The Commission has consistently held that open-account debt or mere advances of money by or to a carrier are not securities within the meaning of Section 20a, and that the statute is "restricted to evidences of interest in or indebtedness of a carrier that are similar to or in the nature of stocks, bonds, and notes." Lehigh Valley RR Conditional Sale Contract, 233 I.C.C. 359, 362 (1939). In its July 28, 1975 opinion, the Commission carefully considered, and rejected, REA's claim that the non-negotiable debt represented "securities" under Section 20a. 348 I.C.C. at 206-09. This finding by the Commission stands unchallenged on this appeal, and, in all events the Court should give great weight to this

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*/ At the time of the passage of the Clayton Act in 1914, securities were generally defined as having reference to written instruments, such as bonds or stock, the same definition later used in Section 20a. See In re Stark's Will, 149 Wisc. 631, 134 N.W. 389, 399 (1912).

finding, bottomed as it plainly is on a "long-standing interpretation of Section 20a by the administrative body to which its enforcement [is] committed." New York, C. & St.L.R.R. v. Frank, 314 U.S. 360, 372 (1941).

Section 10 of the Clayton Act, which antedated Section 20a, is a criminal statute, carrying with it the possibility of a fine and a jail term, and its prohibitions are to be "construed strictly, not loosely." United States v. Boston & Me. R.R., 380 U.S. 157, 160 (1965). It is implausible that the term "securities" in Section 10 was intended to be construed more broadly than the same term in Section 20a, a later, non-criminal regulatory statute.*/

Moreover, the transactions involving the non-negotiable debt did not represent "dealings" in securities within the meaning of Section 10 because they took place between a subsidiary and all its parents and did not involve outside lenders or borrowers or the general public. See

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*/ This Circuit has recognized with respect to Section 20a that "in this early essay in Federal security regulation, Congress did not enact so comprehensive a definition of 'security' as it later did in the Securities Exchange Act of 1933, 15 U.S.C. § 77b(1), the Securities Exchange Act of 1934, 15 U.S.C. § 78c(a)(10), and the Public Utility Holding Company Act of 1935, 15 U.S.C. § 79b(a)(16)." United States v. New York, N.H. & H. RR, 276 F.2d 525, 533 (2d Cir. 1959), cert. denied, 362 U.S. 961 (1960). Section 10 of the Clayton Act was of course an even earlier "essay" by Congress into the regulation of securities and presumably no more comprehensive than Section 20a.

Securities of Western Pac. R.R., 145 I.C.C. 750, 752 (1928) ("[w]hile the two companies have directors in common, it is our view that the proposed transaction is not dealing in securities coming within the inhibition of Section 10 of the Clayton Antitrust Act"). See also Borg v. International Silver Co., 11 F.2d 147, 150 (2d Cir. 1925) (a "dealing" in shares of stock "implies ordinarily a trade between two opposite parties, of which there was none here. The defendant was in substance both the transferor and the transferee.").

REA also fails to grasp that Section 10 is an antitrust law, and not merely a federal substitute for state corporate law doctrines on conflict of interest and fiduciary obligations. See United States v. Boston & Me. R.R., supra, at 160. The Supreme Court has made it clear that Section 10 is "a rather narrow prohibition applicable to activity that is conceptually within the antitrust philosophy." Id. at 162. The risks of illicit mulcting or of anticompetitive conduct made possible through opportunities presented by an interlocking directorship are not risks to be rationally apprehended where all the owners of the carrier jointly act and deal on a uniform basis with their subsidiary. Any injury resulting from director interlocks with all the owners of a carrier is necessarily sustained by those supposedly inflicting it. The relationships between the owner

of an entity and that entity do not constitute "activity that is conceptually within the antitrust philosophy." Accordingly, it makes no sense to invoke the statute. See Cleary v. Chalk, 488 F.2d 1315, 1321-24 (D.C. Cir. 1973).

2. Antitrust Immunity

Even were Section 10 to be regarded as applicable to the creation of the non-negotiable debt, immunity from that application of the Clayton Act has been provided by Commission action. Moreover, it is our contention that the Commission's pervasive regulatory authority over financial relationships between REA and the railroads preempted the antitrust laws as to those relationships. See Hughes Tool Co. v. Trans World Airlines, Inc., 409 U.S. 363 (1973). These points are developed in detail in our "Memorandum in Support of Supplemental Motion for Summary Judgment by Certain Railroads," filed herein in Civil Action 71-4278 on June 1, 1976, pp. 34-59.

We note that the Commission in its July 28, 1975 opinion observed that:

> "The railroads make a persuasive argument that our approval of the railroads' control of REA under section 5(2), which established REA as, in effect, an agency or instrumentality of the railroads with interlocking directors, with no terms or conditions imposed by us on the railroads' exercise of control of REA, and

> with our knowledge of the sinking fund, makes the 'relief' provisions of section 5(11) applicable to the Non-Negotiable Debt." 348 I.C.C. at 217.

It is also observed as to the preemption question, "[w]e are sympathetic to [the] reasoning" that "our regulation of the relationship between the railroads and REA was so pervasive as to preempt the operation of the antitrust laws as applied to the challenged transaction." 348 I.C.C. at 215.

By reason of immunity and preemption no violation of Section 10 of the Clayton Act occurred with regard to the non-negotiable debt. Accordingly, it cannot be argued that the Commission's 1959 order under Section 20a was fatally deficient because of the Commission's failure to perceive the earlier violation.

### C. The Commission Did Not Err in Failing to Decide Whether the Clayton Act Was Applicable to the Non-Negotiable Debt.

REA argues (pp. 8, 23, 24) that the Commission could not properly authorize the 1959 notes without first deciding whether the underlying non-negotiable debt had originally been created in violation of Section 10 of the Clayton Act, and on finding a violation, should have refused to approve the issuance of the notes.

Insofar as REA views the Section 10 violation as inhering in the alleged misappropriation of the sinking fund or supposed manipulation of debt, the Commission did consider in exhaustive detail the facts concerning such alleged misconduct. It rejected REA's charges and held the non-negotiable debt to be valid debt. 348 I.C.C. at 204. In this respect the Commission has considered and ruled on the question which REA claims to require consideration.

If REA's stress is in the fact that the Commission did not decide whether the absence of competitive bidding on the non-negotiable debt violated Section 10, then, also as explained above, no error occurred because Section 10 was inapplicable. But, in addition, an answer to the question whether or not the creation of the non-negotiable debt might have violated the Clayton Act was simply not material to the Commission's execution of its responsibility under Section 20a in considering whether to approve the issuance of the 1959 notes.

If Section 10 were violated in this case, the injury is that attributable to the fact that the non-negotiable debt was issued without competitive bidding and not that the debt was incurred. <u>See</u> <u>Klinger</u> v. <u>Baltimore & O. R.R.</u>, 432 F.2d 506, 512-13 (2d Cir. 1970) ("in an action for damages under Section 10, the relevant inquiry into the value of the interest sold must be what price would have

been reached by competitive bidding"). Section 10 carries criminal penalties and permits collection of damages, but has never been read as allowing a carrier which has borrowed money to refuse to repay the principal because the borrowing had been done without competitive bidding. To the contrary, the doctrine even in antitrust cases is that "the courts are to be guided by the overriding general policy . . . 'of preventing people from getting other people's property for nothing' . . .." Kelly v. Kosuga, 358 U.S. 516, 520 (1959).

Here, the railroads had advanced money to REA by taking reduced amounts of rail transportation revenue, and REA had used that money to repay its public debt. As found by the Commission, this resulted in a "valid debt" from REA to its railroad owners. 348 I.C.C. at 204. Under these circumstances, it would have been entirely improper for the Commission in 1959 to declare the non-negotiable debt to be void because of a supposed failure to secure competitive bidding 30 years earlier.

When the possibility that the debt was sham or otherwise non-existent arose, the Commission conducted an extensive examination which resulted in its detailed conclusions of 1975 as to why the debt was valid. The

Commission's responsibilities under Section 20a involve determinations as to whether a proposed issuance of securities is "lawful," "compatible with the public interest," and "necessary or appropriate for or consistent with the proper performance by the carrier of service to the public." Section 20a did not place a duty on the Commission in 1959 to dig back through 30 years of history to see if it might ferret out some violation of law that might have earlier occurred, and the fact that the Commission conducted no such investigation in 1959 was not improper. Having found in the reopened proceeding that the debt did exist, it was not essential that the Commission also find whether the Clayton Act had been violated for failure to secure competitive bidding in 1929.

REA's reliance on the Supreme Court's decision in Denver & Rio Grande Western R.R. v. United States, 387 U.S. 485 (1967) is misplaced. That case does not stand for the proposition asserted by REA, that the Commission under 20a must consider all alleged violations of the Clayton Act. That case instead involved an approval of the issuance of stock under Section 20a which was the proposed first step in the control of REA by a competitor, the Greyhound Bus Company. The Court held that the standards of Section 20a

"require at least some degree of consideration of control and anti-competitive consequences when suggested by the circumstances surrounding a particular transaction." 387 U.S. at 492. No such questions are presented by the instant case. There was no imminent proceeding in 1959 involving the acquisition of REA by a competitor. There was no future step contemplated involving REA which required antitrust analysis.

## II. The ICC Properly Approved the Issuance of the 1959 Notes Under Section 20a.

Under the second argument heading in the June 1, 1976 brief, REA argues that the Commission's Section 20a authorization of the issuance of the 1959 notes was improper because the notes were unrepayable by REA, they placed an "extraordinary future burden" on the express business, they were "deliberately intended to injure other creditors," their purpose was to maintain the roads in "a dominant position" over REA, and they inevitably led REA down the path to bankruptcy (REA Brief, pp. 10-12). REA demands that the Commission approval be vacated and the notes voided.

The factual premises of REA's argument, such as the cause of REA's insolvency and the intent of the parties

in issuing the notes, will be dealt with below. Initially, however, we note two general respects in which REA's argument is flawed.

First, a determination as to whether a particular issuance of securities meets the requirements of Section 20a is the "primary responsibility" of the Commission, United States v. Chicago, N.S. & M. R.R., 288 U.S. 1, 14 (1933) and its jurisdiction over the issuance of securities is "exclusive and plenary." In making such a determination, the Commission has "broad discretion" and its decision needs only a "rational basis" in order to be upheld. Chicago S.S. & S.B. R.R. v. United States, 221 F. Supp. 106, 109 (N.D. Ind. 1963) (three-judge court). A party seeking to overturn or modify a Commission's order under 20a has "the burden of showing that it is unjust and unreasonable" and that the decision was "arbitrary, capricious and erroneous because . . . not based upon any substantial evidence." Id. Here, however, the Commission has twice considered whether the issuance of the 1959 notes met the requirements of Section 20a, and in both instances has found, without dissent, that the statutory standards were satisfied. These determinations cannot lightly be overturned absent a showing -- which REA does not even purport to make -- of substantial evidence indicating a gross abuse of discretion on the part of the

Commission. Instead, REA in its brief relies on generalized allegations of wrongs and injury (largely without citation to the record), does not dispute the particular findings of fact of the Commission, and ignores the fact that the Commission already weighed the evidence that it now cites (e.g., the statement of L. John Eichner) and found it wanting.

Second, REA misconceives the issue that was before the Commission in 1959 when it was asked for approval to issue the notes. REA erroneously assumes that the Commission had the option of wiping out the debt altogether. In fact, the question for the Commission in 1959 was whether it was appropriate and in the public interest for an existing open account debt of REA to be replaced on a dollar-for-dollar basis by the promissory notes. The Commission had no authority simply to erase REA's debts because of "public interest" considerations, although this obviously would have strengthened REA's balance sheet -- as it would improve the financial situation of any company.

A. The Claim That the Notes Were "Unrepayable" and an "Extraordinary Future Burden"

REA's brief seeks to create the impression that the burden of the $27 million in promissory notes issued to the railroads in 1959 was the dominant fact in REA's financial

structure thereafter and out of proportion to the other items on its balance sheet and income statement. Examples of REA's annual reports to the Commission place the significance of the debt in context.

In 1959, REA paid $953,000 in interest on the non-negotiable debt and the advances. In the same year, it received gross revenues of $397 million, incurred total operating expenses of $249 million, and made payments to carriers for hauling express of $146 million. (App. __) Similarly, in 1966, REA had gross operating revenues of more than $431 million, operating expenses of $300 million, paid $111 million to carriers for hauling express shipments, and paid less than $1.4 million in interest on the notes. (App. __) Plainly, the interest costs could not be determinative of REA's financial health and given the size of the gross revenues, achievement of only a modest margin of profit on REA's gross revenues was necessary to give it the wherewithal to repay the notes. There was, therefore, no inherent implausibility in the proposition that an REA operating on a new profit-loss basis as proposed by the 1959 SEOA could service the notes and ultimately repay them.*/

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*/ REA seeks to exaggerate the degree of the burden by referring to the fact that $30.3 million in interest was paid on the advances and the notes through 1961. (REA Br., p. 21) But REA was a non-profit entity through 1961 and if this sum had not been paid to the railroad debt holders as interest, it would have been paid to the railroads as rail transportation revenue.

Other contentions allegedly supporting the proposition that the notes were clearly "unrepayable" are similarly contrived and unsupported by the facts. Hence it is claimed that the balance sheet did not reveal the existence of large sums of unfunded liabilities (REA Br., p. 18). And it is further asserted that enormous contingent liabilities might be incurred in the event of liquidation of REA (p. 19).

But the question of the materiality of unfunded liabilities was carefully examined by the Commission, and it ruled that there were no material misrepresentations in 1959. 348 I.C.C. at 212. Moreover, the possible presence of unfunded liabilities -- i.e., certain expenses handled on a pay-as-you-go basis -- no more indicated that the notes were unrepayable than did the fact that each year REA had normal operating expenses in the hundreds of millions of dollars. And the asserted existence of possible liabilities in the event of liquidation of REA upon examination turns out to be speculation as to the costs to railroads of providing alternative express services should they be required

to furnish them. It is hardly material to REA's ability as a going concern to earn revenues to repay the notes.*/

The hard evidence on what sophisticated businessmen were in fact willing to do at the time in question far outweighs present efforts by REA to conjure up supposed "unpayability" or "extraordinary burden" in the past. For example, REA refers in its brief (p. 20) to an offer made by Lehman Brothers in 1959 to purchase the express business. REA fails to point out that Lehman Brothers offered to buy all of REA's stock for $500,000 and promptly to shoulder the "burden" of the entire non-negotiable debt with promissory notes of over $28 million, the notes to be issued by REA, and the _entire_ principal to be repaid by the end of 1960. (REA Ex. 66) Nor does REA ever seek to explain why the inside managers of REA in 1969 arranged for the purchase of REA, notes and all, if the debt was the deadly, unpayable burden it is now claimed to be.

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*/ REA relies on written testimony of one of its witnesses in the 1975 proceeding for the proposition that the issuance of the notes was injurious to REA's performance as a common carrier. But this witness's contentions were sharply disputed by the railroads and their witness (Verified Statement of Prof. James E. Walter, App. __) and no reason is advanced why the court should now decide that the Commission's 1975 decision was without evidentiary support.

REA's contention that the sinking fund provision in the notes was "a tip-off" to the unrepayability of the notes does not withstand analysis (p. 26). In the record before the Commission are copies of the correspondence of REA's Finance Committee which drafted the notes in July and August, 1959. (RR Exs. 92-96, App. __) This correspondence, ignored by REA, states that the reason the sinking fund did not begin to operate until 1965 was because of a restriction in a loan agreement with Guaranty Trust Company against retirement of other debt prior to maturity of Guaranty's loan in 1965. There was no sinister reason why amortization would otherwise not have been commenced earlier; and there was no prohibition against repayment at a greater rate than 10% once amortization could begin.

Finally, in conjunction with the claim that the notes were unrepayable _ab initio_ is the recondite theory that the railroads wished this to be so in order to maintain "permanent indirect control of REA" by being a principal creditor (pp. 10, 26). There is no basis in the record for this contention and it is at war with common sense. The railroads clearly would much prefer to have their debt repaid at the time of transfer to new ownership and not be creditors. And if control of REA was desired, the railroads could have perpetuated that by not selling REA.

## B. The Claim that the 1959 Notes Caused REA's Bankruptcy

It is repeatedly asserted throughout REA's brief that the 1959 notes were the major cause of REA's subsequent bankruptcy.

There is no evidence in the Commission record to support this assertion and the allegation is made by REA without reference to supporting evidence. It should be disregarded. It also is a patently implausible claim. By REA's own calculations, it paid only $13 million in interest on the 1959 notes after its non-profit status ended in 1961. (REA Br., p. 21).*/ It stopped paying any interest on the notes in 1971, when this lawsuit started. It did not pay the principal when it became due in 1973. In 1974, three years after REA made its last payment on the notes, it achieved an operating profit of $2.8 million. (Livingston Aff. of April 28, 1975, Ex G.)

When REA went into reorganization in 1975, it did not attribute its difficulties to the existence of the notes. In an affidavit filed by the president of REA at the time of the reorganization, he stated that although REA had earned a profit in 1974, it had lost $3 million in January 1975 and that the immediate prospects for prompt

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*/ As previously noted, interest payments to the railroads during the period of non-profit operation amounted to "wash" transactions with no detrimental effect on REA.

payment of creditors were bleak. (Livingston Aff. of April 28, 1975, Ex F.) No suggestion is contained in that affidavit that REA's difficulties had resulted from the notes, on which it had stopped making any payments four years earlier. Instead, the affidavit attributes REA's problems to "the combined effect of double-digit inflation and the most severe recession since World War II," the limited availability of credit, and similar problems. (Id.) In a press release issued at the time of reorganization, it was again emphasized that "the effects of the recession has literally pulled the rug out from under our carefully planned recovery program and our cash position during the past two months has become critical." (Id., Ex. G.) Again, no suggestion was made that the notes were a cause of the bankruptcy, as is alleged in REA's present brief. The claim, in short, is untrue and unsupported by any evidence.

C. The Claim that the Notes Were "Deliberately Intended to Injure Other Creditors."

The claim is made that Section 20a authorization should not have been granted because the notes were a fraud on REA's creditors and were intended to give the railroads "first claim" on REA's assets as against other creditors. (REA Br., pp. 18, 26.)

This contention, too, cannot withstand the light of day. The correspondence of the Finance Committee that drafted the notes discloses their agreement that the notes should be subordinated to REA's then existing debt, and appropriate subordination clauses are included in the terms of the notes. (RR Exs. 92-96, App. __.) Thus, 1959 creditors of REA could not have been the target of fraud. And there is no evidence in the record that any creditor from that period did not receive full repayment of his debt.

As for later creditors, it is difficult to conceive how they could be the victims of fraud. The existence of the promissory notes was shown on REA's annual reports and its financial statements, and their existence was a matter of public record at the Commission. Again there is no evidence whatsoever that any creditor loaned money after 1959 in ignorance of the existence of the notes or that any fraud was perpetrated on such creditors.

In fact when subsequent lenders required subordination of the notes as a condition to further loans, far from seeking to maintain a preferred position among creditors, REA in 1961 sought and obtained Commission approval to modify the 1959 order to permit the holders of the notes to subordinate them to new loans from outsiders to REA. (RR Ex. 100, 1976 Livingston Aff., Ex. 20.)

Finally we note the discontinuity between REA's purported concern for other creditors and the relief requested. The supposed grievance is in the nature of preferences which presumably, had they existed, could be rectified by subordinating the notes in the bankruptcy proceeding. But the present plea is for voiding the notes. And this is made in the context of an effort to subject the former railroad owners to extensive damage claims. No reason is suggested in the facts or in the law or equity for invalidating the notes and exposing the railroads unjustifiably to enormous liabilities.

### III. Neither the Commission nor the Court Has Authority to Vacate the Commission's 1959 Approval, and the Reviewing Court Has no Authority to Void the Notes or to Award Damages

REA requests not only that the Commission's approval of the issuance of the notes be vacated and set aside, but that the Court also declare the notes to be void and order the railroads to pay to REA's Trustee the amounts collected as interest on the notes between 1959 and 1971. The relief here sought by REA cannot be granted.

### A. There is No Authority to Vacate The Commission's 1959 Approval In View of the Justifiable Reliance On the Validity Thereof

When the three-judge court stayed REA's lawsuit against the railroads to permit the Commission to reconsider the appropriateness of its approval in 1959 of the notes, it noted that the Commission's power to revoke that order "is by no means plain." Indeed, considering the nature of the 1959 order, issued over 15 years ago, and the substantial and extended reliance on it by many parties, there are strict limitations on the power of the Court or the Commission to reconsider, modify or revoke prior orders.

In ordinary circumstances, the Commission has considerable authority, as do other administrative agencies, to make new policies in light of changing circumstances and to require that those policies be given future application. See, e.g., American Trucking Ass'ns, Inc. v. Atchison, T. & S.F. Ry., 387 U.S. 397, 416 (1967). Similarly, courts reviewing Commission orders may revoke those that have been improperly entered. By contrast, however, obvious injustice would result if the Commission or Courts had unconfined authority to reach back in time and vacate approvals under Section 20a of bonds, notes or other securities and thereby to render them void. The power so to act is limited.

Where securities of a common carrier have been approved and issued, have been assigned or sold, have begun to circulate in money markets, or have in other ways been relied upon, the railroads, the financial community, and the purchasers of these securities must have confidence that the underlying agency approval of the issuance will not be revoked except in rare circumstances. The special problems raised by a retroactive disturbance of authorizations to issue securities is recognized by Section 20a itself. By its terms, Section 20a prevents the voiding of an issuance of securities which, as here, has complied in all respects with the Commission's order of approval:

> "no security issued . . . in accordance with all the terms and conditions of [the ICC] order of authorization . . . shall be rendered void because of failure to comply with any provision of this section relating to procedure <u>and other matters preceding the entry of such order of authorization</u>." 49 U.S.C. § 20a(11) (emphasis added).

More generally, courts have recognized the principle that the Commission's power to reconsider its orders may be limited "where the objecting party demonstrates detrimental reliance or the passage of a long period of time." <u>Chicago & N.W. Ry.</u> v. <u>United States</u>, 311 F. Supp. 860, 864 (N.D. Ill. 1970) (three-judge court). For instance, a certificate of convenience and necessity may not be modified or changed simply in order to apply a new policy or because

the wisdom of a prior policy becomes doubtful in view of changing circumstances. See, e.g., American Trucking Ass'ns, Inc. v. Frisco Transp. Co., 358 U.S. 133, 146 (1958); United States v. Seatrain Lines, Inc., 329 U.S. 424 (1947); Garrett Freightlines, Inc. v. United States, 324 F. Supp. 575, 576 (D. Ida. 1971) (three-judge court). Similarly, the Commission does not have authority to reopen or correct a reparations order where to do so "would result in chaos and uncertainty of action for those who must rely on its findings." Upjohn Co. v. Pennsylvania R.R., 381 F.2d 4, 5 (6th Cir. 1967).

The reluctance of the courts to permit reversals of prior administrative action involving the issuance of securities where there has been extensive reliance on the Commission's action is exemplified in United States v. Chicago, N.S.&M. R.R., 288 U.S. 1, 14 (1933), and in New York, C. & St. L. R.R. v. Frank, 314 U.S. 360 (1941).

The doctrine preventing the revocation of orders on which there has been substantial reliance perhaps would have no application if the order had been induced by fraud or misrepresentations. But the Commission expressly found that the "numerous allegations of misrepresentations and omissions" made in REA's brief before the Commission concerning the application in 1959 for authority to issue the notes were "without any substantial basis." 348 I.C.C. at 212.

In its order of reconsideration, the Commission reiterated that "the application for the issuance of the 1959 Notes disclosed all facts insofar as they were material to such authorization." (App. __.) And REA's brief does not challenge these conclusions.

In this case, the reliance by the parties on the correctness of the Commission's order approving issuance of the notes, and their like reliance on the validity of the notes during a 15-year period, was substantial and justifiable. This is to be expected in the case of a securities issue of more than $27,000,000 which stood unchallenged for more than twelve years, and an effort now to revoke that order for whatever reason would have the most unjust consequences.

During the first twelve years following the issuance of the notes, neither the parties to the notes nor the Commission ever intimated that the notes were invalid. Interest was regularly paid on the notes. Some of the original holders of the notes, believing them to be valid, have sold or assigned them to parties who were unconnected with the railroads or with REA, who also believed the notes valid. Hence the complaint in this litigation names three "Defendant Assignees" including Bankers Trust Company. (See also Amended Answer Counterclaim and Crossclaim of Bankers Trust Company as Custodian for Montefiore Hospital and Medical Center, filed in this case.)

When REA was sold in 1969 to REA Holding Corporation, Inc., the amount paid the railroads (slightly over $2 million in cash plus warrants in the Holding Corporation) was fixed on the assumption that REA's debt, represented by the notes, remained outstanding. Five executives of REA organized and controlled the REA Holding Corporation in order to purchase the railroads' stockholdings in REA. There has been and can be no claim or suggestion that in arranging for the purchase of REA these REA officials were not fully aware of the existence of the 1959 notes and of the fact that the notes would fall due in 1973.

The purchase arrangements between REA Holding Corporation and the sellers of the railroads' stock expressly recognized the existence and validity of the 1959 notes. 348 I.C.C. at 191-92. The notes could be applied to the payment for stock under warrants of the Holding Company; and cash received in the exercise of warrants was to be contributed by the Holding Corporation to REA for application to payment on the notes. (Id.)

It is obvious that if the selling stockholders in 1969 had an inkling that the 1959 order authorizing issuance of the notes was not valid and that they could in fact be selling ownership of an REA unencumbered by $27 million in debt, the terms of the sale would have been vastly different. Instead, both buyers and sellers reasonably

and justifiably relied on the ICC's then ten-year-old order as entirely valid since neither the Commission nor anyone else had ever suggested otherwise.

At the very least, therefore, if the Commission's order approving the 1959 notes were now to be revoked, gross injustice would result. Assignees of the notes would be stripped of their justifiable expectation that they held valid notes. The selling stockholders would find retroactively that the valuation placed on their stock had proceeded on a gross miscalculation that the entity they owned was encumbered by a valid indebtedness to them of $27 million.

In view of the substantial reliance by the parties on the validity of the Commission's order, it cannot now be overruled. As held by the Supreme Court in a case involving a prior Commission interpretation of Section 20a,

> "Whether we would agree with the Commission's interpretation of the Act as an original matter, it is not necessary to decide. Considerations of public interest certainly should have weighed heavily in favor of the Commission, had it asserted power to review the debts of the new company before giving even tentative and formal approval to capitalization of its equity. What we must now decide is the present effect of the Commission's interpretation of its powers as to the indebtedness of this particular appellant, woven, as it has been, by a series of actions by the Commission, into the whole financial fabric of this important carrier system. We are now asked blindly to unravel we know

> not what, by reversing a consistent and longstanding interpretation of § 20a by the administrative body to which its enforcement was committed." New York, C. & St. L.R.R. v. Frank, 314 U.S. 360, 372 (1941).

Under these circumstances, therefore, where the "primary responsibility" for interpreting 20a "rested upon the Commission," and where all interested parties "have acted in reliance on the administrative tribunal's construction of [Section 20a]," the original order of approval cannot be set aside. United States v. Chicago N.S. & M.R.R., 288 U.S. 1 14 (1933).

B. The Reviewing Court Cannot Void the 1959 Notes Nor Order Payment of Damages.

REA's petitions and brief seek not only to set aside the Commission's decision and orders but also request the Court to declare the 1959 notes to be void and to order the railroads to repay with interest past interest payments (of more than $13,000,000) on the notes.

There is, admittedly, less than complete certainty as to whether review is under the old Urgent Deficiencies Act, or under the new legislation, or under Section 1336(b). But in all three instances, the Court's jurisdiction is established by statutes solely intended to provide procedures for judicial review of Commission action. See Schwartz v. Alleghany Corp., 282 F. Supp. 161, 163 (S.D.N.Y. 1968) ("The

only claim of which this court, constituted under the Urgent Deficiencies Act, can take cognizance is a claim that an ICC order or orders are invalid"). In each instance, the scope of review is limited, the review is confined to the administrative record, and the petitioner has the burden of showing that the order was not supported by substantial evidence, or has no rational basis, or for some reason was beyond the Commission's authority to issue. See, e.g., Interstate Commerce Commission v. Jersey City, 322 U.S. 503, 512-13, 523 (1944); State of New York v. United States, 299 F. Supp. 989, 994 (N.D.N.Y. 1969) (three-judge court), aff'd per curiam, 396 U.S. 281 (1970).

This Court's power in considering REA's petitions for review is thus properly limited to deciding whether the Commission's action was proper. It does not include authority to rule on what effect overruling the Commission's decisions would have on the liabilities between REA and the railroads, such as by voiding the promissory notes in this case, or to require that money be paid from one private party to another.*/

Moreover, the relief sought by REA is also sought in the amended complaint now pending against the railroads in Civil Action 71-4278 in the Southern District. In that litigation, the railroad defendants have denied liability, have

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*/ The extraordinary nature of REA's request for relief is indicated by the fact that the railroads are parties in the instant proceeding before the Court of Appeals only as intervenors.

asserted counterclaims, and have filed motions for summary judgment based on numerous grounds, including the statute of limitations, antitrust immunity and preemption, and the effect of the sale of REA to new owners in 1969 after the alleged wrongs occurred. With those motions now pending in the district court, and where it is plain that the railroads have many substantial defenses to the payment of any money to REA, it would be neither proper nor necessary for the reviewing court in this proceeding to grant monetary relief to REA and effectively negate the defenses raised by the railroads in that lawsuit and effectively dismiss their counterclaims.

In addition, the grounds on which REA seeks to vacate the Commission's order include certain factual matters, such as the supposed relationship between the 1959 notes and REA's bankruptcy, the alleged intent of the railroads in issuing the notes, and the asserted defrauding effect of the notes on creditors. We regard REA's assertions concerning these factual matters as without any evidentiary basis but for present purposes it is sufficient to note that REA's factual allegations are at least subject to serious dispute. Monetary relief should not be granted on the basis of its allegations absent a full evidentiary hearing, the conduct of which is not the function of a court limited to the review of the correctness of Commission action.

CONCLUSION

For the reasons stated above, the Commission's decisions and orders of September 25, 1959, July 28, 1975 and February 11, 1976 in Finance Docket 20812 should be affirmed, and REA's Petitions for Review of September 26, 1975 and April 8, 1976 should be dismissed.

Respectfully submitted,

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June 30, 1976

CERTIFICATE OF SERVICE

I hereby certify that two copies of the attached "Brief for Defendants and Intervenors" was sent to each counsel appearing in this case for other parties by depositing same in the United States Mail, postage prepaid, this 30th day of June, 1976, addressed to:

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